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FEATURE COMMENT: Defective Pricing And Truth In Negotiations: Statutory Requirements, Increased Audits And Practical Resolutions

After a multi-year marathon to reduce its incurred-cost audit backlog, the Defense Contract Audit Agency is now targeting another type of audit: defective pricing. DCAA recently announced its intent to triple the number of defective-pricing audits of contractors in fiscal year 2020 and is ramping up staff by as much as 500 percent in this area. This renewed focus on defective pricing marks an important shift and heightens risks for contractors that submit certified cost or pricing data to the Government.

The Truthful Cost or Pricing Data Act—often still referred to by its prior name, the Truth in Negotiations Act (TINA)—when applicable requires contractors to submit certified cost or pricing data that is accurate, complete and current. Violations of this mandate can entitle the Government to a price adjustment equal to the increase in price related to the defect, including profit or fee plus interest. Where a contractor shows reckless disregard of the truth, severe penalties are available to the Government under the civil False Claims Act.

This article describes the TINA requirements, DCAA's renewed focus on defective-pricing audits, and practical ways to resolve these audits without the need for protracted litigation. Finally, the article closes by discussing the Government's heightened scrutiny on "excessive" profits that, while not constituting TINA violations per se, can be problematic for contractors.

Statutory Requirements—Contracting officers must purchase supplies and services from responsible sources at fair and reasonable prices. TINA (10 USCA § 2306a, 41 USCA chapt. 35, and 48 CFR § (FAR) 15.402) requires offerors to submit "certified cost or pricing data" if a procurement exceeds the TINA threshold and none of the exceptions to certified cost or pricing data requirements apply. The current TINA threshold is $2,000,000, up from $750,000 beginning June 30, 2018. This threshold applies both to the original contract action and subsequent modifications that meet or exceed the threshold, as well as to subcontractor submissions to prime contractors. Exceptions to TINA include acquisitions and modifications to procurements of commercial items, price agreements based on adequate price competition or law and regulation, and when a waiver is granted by the head of the contracting activity in exceptional cases.

When applicable, TINA requires contractor's cost and pricing data to be accurate, complete, and current to establish a fair and reasonable price. The Federal Acquisition Regulation defines cost or pricing data as verifiable facts, not judgments, available at the date of the price agreement. Cost or pricing data goes beyond mere historical accounting information; it includes all facts that can be reasonably expected to contribute to the soundness of estimates of future costs and to the validity of determinations of costs already incurred. Examples of cost or pricing data may include vendor quotations, purchase orders, labor hours and trends, and other factual data bearing upon the price negotiations.

Defective pricing may occur when a contractor submits certified cost or pricing data that is defective—i.e., inaccurate, incomplete or noncurrent. DCAA's Contract Audit Manual states that the Government can reduce the contract price if the agency establishes, by a preponderance of the evidence, the five points of defective pricing:

1. the information in question fits the definition of cost or pricing data;
2. the data existed and were reasonably available;

3. the data were not disclosed to the Government;
4. the Government relied on the defective data to its detriment; and
5. the Government's reliance caused an increase in the contract price.

Penalties for Defective Pricing—TINA provides agencies both contractual and civil remedies for defective pricing. Where the agency can establish that the contractor submitted defective pricing, it can adjust the price by the increased amount attributable to the defect and associated overhead and profit or fee, plus interest. Where the contractor acted with reckless disregard, the Government may pursue damages under the civil FCA, which provides for treble damages and statutory penalties. In our experience, many defective pricing audits become FCA claims. Beyond financial impact, the accusation of fraud by the Government can bring reputational risk for the contractor and possible adverse impacts on future procurements.

A TINA violation by itself does not constitute fraud unless, at a minimum, the Government can prove that the violation was committed with objective falsity. The Department of Defense inspector general issued a handbook of fraud indicators for Government auditors with a specific section (Section IV) covering fraud indicators for defective pricing such as:

1. falsification or alteration of supporting data;
2. failure to update cost or pricing data even though decreased prices were known;
3. significant knowledge of cost issues that would reduce the cost to the Government were not disclosed;
4. high contractor prices compared to similar contracts, price lists, or industry averages;
5. failure to record rebates and discounts;
6. unrealistically high profit margins; and
7. known system deficiencies leading to defective pricing that remain uncorrected.

Increasing Defective Pricing Audits—Over the past two years, the Pentagon has repeatedly claimed that defense contractors have substantially increased their profit margins by using defective cost and pricing data in contract negotiations. Rather than profit rates of 12–15 percent that DOD finds reasonable, some contractors have achieved profits of 25–80 percent. According to Shay Assad, the Pentagon's former director of defense pricing and contracting, these high profit levels "do not happen by outstanding performance" but by faulty contractor cost estimating "or in the worst case, fraud."

DOD's findings have prompted Congress to dedicate more resources to enforcing TINA. The 2020 federal budget earmarked $1.2 million for additional civilian auditor positions to "target contractor defective pricing to ensure compliance with the Truth in Negotiations [Act] allowing the Government to recover amounts due to the contractor's failure to provide accurate, current, and complete cost or pricing data." This budget increase does not account for the many current auditors that will shift their focus from incurred cost audits to defective pricing. As these actions show, defective pricing is a strategic priority for DOD. Other agencies have followed suit, with the Environmental Protection Agency proposing additional funds in its FY 2020 budget request for more defective pricing audits and investigations.

From 2015 to 2019, DCAA had only 20 auditors reviewing high-risk contracts for defective pricing. Of the 100 contracts audited, they found potential defective pricing in nearly 75 percent. A good number of those audits were referred for civil FCA and even criminal investigation. According to former director Assad, "[i]f one looks deep enough there is some element of fraud typically lurking." According to our sources at DCAA, FY 2020 will see a three-fold increase in defective pricing audits and a five-fold increase in the number of auditors assigned to defective pricing matters. However, many of DCAA's seasoned veterans in defective pricing and TINA are no longer with the agency, and the auditors shifted from incurred cost audits have little or no experience with TINA. As a result, contractors should expect an increase in unsupportable audit findings, thus requiring additional resources to counter and effectively resolve negative audit findings.

Practical Advice on Defective Pricing—Having dealt with dozens of defective pricing audits and litigation for more than two decades, we have identified nine measures for avoiding defective pricing problems and, when they do occur, resolving audits to avoid or minimize penalties.

Step 1 Determine Whether the Statute Applies: In some instances, auditors seek to apply TINA without first determining its legal applicability. TINA applies only where the solicitation and contract includes, by express incorporation or operation of law, the clauses relating to price reduction for defective pricing: FAR 52.215-10, 11, 12, and 13. Both the statute and regulation (FAR 15.403-1, Prohibition on obtaining certified cost or pricing data) incorporate mandatory exceptions to submission of certified cost or pricing data, thus

negating a defective pricing claim based upon data exempt from TINA requirements. For example, if an exemption applies for commercial supplies and services, the contractor should be sure to claim and document the exception in the event of a future defective pricing claim. Given the limited judicial precedent in this area, be aware of possible pitfalls and consult legal counsel prior to using them to ensure that you are wholly eligible for the exception.

Step 2 Ensure the Data Are Accurate: The Government must show by a preponderance of the evidence that more accurate, complete, and current cost or pricing data were reasonably available to the contractor on the date of the price agreement for a defective pricing claim to hold merit. Before proceeding with a defective pricing claim, the agency bears a regulatory duty to confirm the reasonable availability of the data at issue. First and foremost, contractors should strive to ensure their policies, procedures and processes include safeguards for identifying and disclosing accurate cost and pricing data for covered procurements. Contractors should examine their controls related to preparation of certified cost or pricing data and ensure they are sufficient and enable the certifier to have a good faith basis that the data are current, accurate and complete on the price agreement date.

Step 3 If an Audit Commences, Quickly Determine Whether the CO Relied on the Cost and Pricing Data: An agency cannot claim defective pricing simply because a contractor may have submitted defective cost or pricing data. For defective pricing allegations to prevail, the Government must also have relied on the certified cost or pricing data to its detriment. We've seen COs use reliance statements as boilerplate templates even though the underlying facts demonstrated that the Government did not rely on the cost and pricing data. For example, in one case the CO testified that he relied upon the contractor's cost or pricing data to determine price reasonableness, but his annual option-exercise memoranda uniformly cited the "market test between the competitors" as the basis for finding prices fair and reasonable. *United Techs. Corp.*, ASBCA 51410 et al., 05-1 BCA ¶ 32860 at 162,813; 47 GC ¶ 86, aff'd, 463 F.3d 1261 (Fed. Cir. 2006); 48 GC ¶ 338.

Step 4 Establish Credibility and Trust with Government Auditors: The initial stage of DCAA's defective pricing audit is actually just a risk assessment, not the audit itself. This is an important distinction because contractors should act swiftly and effectively during the risk assessment to minimize the potential of a longer, more costly audit. The purpose of DCAA's risk assessment is essentially to determine if an audit is warranted. First, auditors notify contractors to coordinate a walkthrough of the final certified pricing position and the major events associated with the pricing action. During the risk assessment, auditors will likely request to see information such as significant subcontracts; significant inter-organizational and divisional transfers, the final certificate of current cost or pricing data, identification of all certified cost or pricing data submitted before or during negotiations, a list of additional data submitted between the date of price agreement and the date of the certificate of current cost or pricing data, and costs incurred to date along with estimates at completion organized by major cost element. If DCAA decides to conduct an audit, auditors will send formal notification letters and invitations to an official entrance conference.

Contractors should present enough information during the risk assessment phase to demonstrate to auditors that defective pricing actions did not occur, and thereby avoid the audit altogether. Demonstrating preparedness, well-written and formally documented policies, procedures, and internal controls, along with efficient production of documents all support a low-risk assessment from auditors. Naturally, auditors may assign higher levels of risk to the contractor if the common documents and policies listed in DCAA's audit program cannot be readily produced or logically defended.

Step 5 Understand the Auditors' Level of Expertise, Approach to the Audit, and any Suspicions: DCAA's Contract Audit Manual chapter 14, Truth in Negotiation Compliance Audits of Contractor Certified Cost or Pricing Data, outlines audit guidelines for defective pricing and is publicly available information. The chief purpose of a TINA audit is to determine if a negotiated contract price increased significantly because the contractor did not submit or adequately disclose accurate, complete, and current cost or pricing data. After the risk assessment, the key steps in the defective pricing audit include establishing the audit baseline, determining if defective cost or pricing data exists, and then recommending a price adjustment, if any.

In general terms, DCAA's common practices include looking for significantly lower actual cost of individual items and cost elements as compared to the amounts in the audit baseline, operations or cost activities that were proposed but not actually performed, or items of direct cost included in the proposal at prices higher

than appropriate based on information available to the contractor. According to DCAA, the price negotiation memorandum (PNM) is the most important Government document for the successful completion of any post-award audit because the PNM addresses many of the facts pertinent to a defective pricing action. Beyond the extent of reliance on cost or pricing data, the PNM can also identify applicable exceptions, pre-award knowledge of defective data, summaries of negotiation positions, and summaries and cost analyses of major cost elements. DCAA's approach to defective pricing will routinely involve significant review and reliance on the information within the PNM along with the other relevant cost and decisional data.

Contractors should be aware of the risks and likelihood of audits conducted without appropriate experience with, and knowledge of defective pricing rules. Currently we see a defective pricing environment highlighted by procurement and audit officials that lack TINA experience, further increasing the need to resolve defective pricing disputes without litigation. Many of the experts that worked for DCAA the last time the agency had a significant focus on defective pricing have retired or no longer work for the agency. Beware of conclusory audit findings and insufficiently supported downward price adjustments. Conduct due diligence with internal or external counsel to formulate an adequate response.

Step 6 Conduct an Internal Investigation to Learn the Whole Story: Conducting internal or external investigations is an excellent tool to adequately prepare for an audit or subsequent litigation. Investigators should review facts and look for common defective pricing risk indicators. For example, does the contractor have poor internal controls around cost estimates for large proposals or are they clearly documented and defensible? Was the price proposal audited? If so, did significant time elapse between the date of the audited proposal and the price agreement date? Had the contractor completed its cost or price analyses on major subcontracts at the time of the price agreement? Was additional cost or pricing data or a substantially modified proposal provided after pre-award? Does the contractor have previous instances of defective pricing violations? Answering these key investigative questions first internally will better prepare the contractor for its defense and hopefully earn credibility with Government officials.

Litigating defective pricing typically involves evidence beyond just the underlying cost or pricing data. Investigators need to identify and vet credible witnesses with first-hand knowledge of the negotiations and cost data. If the witnesses are strong and their testimony is consistent and credible, it may indicate that the contractor has good reason to maintain its position. Circumstantial evidence also plays a central role in defective pricing cases. According to the Armed Services Board of Contract Appeals, "[t]he circumstances surrounding the negotiation and the negotiation strategies employed by the parties are, after all, at the heart of a defective pricing case." *Rosemount, Inc.*, ASBCA 37520, 95-2 BCA ¶ 27770 at 138,456; 37 GC ¶ 540. For example, in one case the board found there was no defective pricing because the parties had never looked at the data or performed the analysis during the negotiations that the auditors advocated in the defective pricing audit. *Lockheed Martin Corp.*, ASBCA 50464, 02-1 BCA ¶ 31784 at 156,944. Investigators should be aware of these possible defenses and identify all the information, decisions and analyses that were actually used during negotiations.

Step 7 Lay Out the Accounting and Legal Case to the Auditors: Contractors often prevail with arguments that the information at issue was not cost or pricing data, the contractor disclosed the data, or the Government did not rely on the allegedly defective data. These defenses should be plainly articulated, fully documented, and legally supported to maximize the possibility of auditor acceptance and, possibly, closure of the audit engagement before it starts. Our approach is to present a clear chronology of all key accounting and cost data buttressed with a legal interpretation of the facts to demonstrate how and why defective pricing did not occur.

Arguing that the price was based on total cost, that there was no agreement about the cost of each item procured, or that the contracting officer should have known the cost or pricing data was defective are legally ineffective positions. Similarly, a contractor's failure to submit a TINA certificate is not a legal defense under the current statute and regulations.

Step 8 If the Auditors do not Agree, Make a Presentation to the CO: Even with an adequate contractor response, auditors may disagree and pursue defective pricing audit findings and recommend a downward price adjustment. Contractors should not feel immediately discouraged or defeated when this happens, many audit issues have been successfully resolved with COs. Auditors, particularly now, may lack sufficient defective pricing experience, thus reaching audit positions inconsistent with the governing statute and regulations, applicable judicial precedent and even DCAA's

own Contract Audit Manual. Agencies that outsource contract audits to private accounting firms, or overseas subsidiaries unfamiliar with U.S. Government contracting standards may produce audit reports that may be unpersuasive to COs and judges. We have teamed with contractors to help gather facts, assess key points and present the best arguments to the CO to avoid costly litigations.

Step 9 If the CO Disagrees, Do Not Hesitate to Mediate or Litigate a Good Case: Once the CO issues a formal written decision, the contractor must determine whether to litigate the Government's claim through the agency board of contract appeals or the Court of Federal Claims. The final determination from the CO starts the clock and contractors have 90 days to appeal to the agency's board or 12 months to appeal to the COFC. Alternative dispute resolution (ADR) is expressly available to agencies and contractors to pursue alternatives to litigation; however, contractors should be aware that the decision to use ADR does not stop the "clock" from running on the contractor's appeal window. If using ADR, we suggest filing the appeal first and then working to resolve the dispute.

If litigation commences, there is case law spanning more than 60 years. The earlier cases identified just two or three elements of defective pricing while many of the later cases offer more complete guidance for Government and industry. One thing is consistent across the spectrum; the patchwork of cases and regulations requires—at a minimum—proof of the following five elements: (1) cost or pricing data, (2) reasonable availability of data, (3) lack of disclosure or Government knowledge of such data, (4) Government reliance upon such data to its detriment, and (5) causation of an increase in price.

Focus on "Excessive" Profits—In addition to enforcing TINA, DOD and Congress are also publicly calling out contractors for earning what have been alleged to be excessive profits, particularly under sole-source contracts.

In 2019, the DOD inspector general found that TransDigm Group Inc., sold parts to the Defense Logistics Agency at profit rates alleged to be excessive, despite the fact that the contractor had been fully compliant with TINA. The IG opined—without citing any law or regulation—that a reasonable profit rate for parts would have been 15 percent, but that TransDigm achieved higher profit rates on nearly all of its parts, as high as 4,451 percent. Those "excessive profits" allegedly resulted in $16.1 million in added costs to DLA and $26.2 million for the Army. The IG recommended that DLA and the Army seek a "voluntary refund from" TransDigm for the excessive costs. Both agencies concurred.

In response to the report, Congress is working on provisions that would make it easier for the Government to obtain cost or pricing data from contractors, and DOD appointed a team of functional experts to scrutinize "other than certified" cost or pricing data more closely for contractors deemed to be at high risk for unreasonable pricing. Contractors should be aware of this newfound skepticism in order to defend pricing actions and avoid the type of public visibility that TransDigm received.

Conclusion—The Government's heightened focus on defective pricing and excessive profits warrants taking extra precautions. For any contractors planning to submit proposals on TINA covered procurements, examine controls around the proposal process and particularly the preparation of certified cost or pricing data. Controls should be sufficient for certifiers to know, with confidence, that cost data are current, accurate and complete. If a defective pricing audit arises, gather the entire story—factual, accounting, and legal—and make a strong presentation to the auditors. By following these practical steps, contractors can avoid more costly FCA investigations and claims litigation, not to mention reputational damage resulting from such Government allegations.

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This Feature Comment was written for THE GOVERNMENT CONTRACTOR by* David Bodenheimer, Robert Nichols *and* Adrian Wigston *of Nichols Liu LLP, a specialized law firm dedicated exclusively to serving Government contractors. David recently became a partner at Nichols Liu and has over 30 years of experience handling defective pricing issues. Chambers USA ranks David nationally and recognizes him as a "top expert on defective pricing" and "an exceptional cost and pricing attorney who is terrific with clients." He is the author of the Defective Pricing Handbook (Thomson Reuters), which has been described by the NASH & CIBINIC REPORT as "the definitive text on TINA." Robert is a partner and handles cost issues at all stages from audit through disputes at the boards of contract appeals. Adrian is a former DCAA and IG auditor and a certified fraud examiner. He handles a litany of cost and pricing issues for Nichols Liu.

